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Date	May 19, 1999	Number of pages including cover sheet	MAY 20 4 10 PM '99

TO: Cheryl T. Farson
General Counsel, Arizona Corporation
Commission, Securities Division

Phone	602-542-4242
Fax Phone	602-594-7470
CC:	

FROM: DOCUMENT CONTROL

Karen L. Barr, General Counsel
Investment Counsel Association of America, Inc.
1050 17th Street NW, Suite 725
Washington, DC 20036-5503

Phone	(202) 293-ICAA
Fax Phone	(202) 293-4223

REMARKS:

☐ Urgent ☒ For your review ☐ Reply ASAP ☐ Please comment

ICAA

May 19, 1999

By Facsimile and Regular Mail

Ms. Cheryl Farson
General Counsel
Arizona Securities Division
1300 West Washington St., 3rd Floor
Phoenix, AZ 85007-2996

Re: Proposed Changes to Investment Adviser Rules Pertaining to Arizona Investment Management Act

Dear Ms. Farson:

We thank you and Sharleen Day for taking the time to speak with us May 12 regarding the Securities Division's proposed investment adviser rules intended to implement the Investment Advisers Supervision Coordination Act. The Investment Counsel Association of America[1] respectfully submits these comments regarding the pending rule proposals, as a follow-up to our comments last August on the draft proposal[2] and to our recent conversation.

The ICAA commends Arizona's comprehensive efforts to implement the Coordination Act. Indeed, although we still have significant concerns with the proposal, we appreciate the consideration that the Division accorded our August comments and the changes to the final proposal that responded to such comments. In particular, we support the Division's changes to the books and records rule (Rule 201) and the brochure rule (Rule 205) that ensure that these rules apply solely to investment advisers "licensed or required to be licensed under the IM Act" in Arizona.

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[1] The ICAA is a national not-for-profit association that *exclusively* represents SEC-registered investment adviser firms. Founded in 1937, our membership consists of more than 240 investment advisory firms that collectively manage funds in excess of $1.8 trillion for a wide variety of institutional and individual clients. More information about the ICAA can be found on the Association's Web site, www.icaa.org.

[2] Letter dated August 31, 1998 to Cheryl T. Farson, Associate General Counsel, Arizona Corporation Commission, Securities Division, from Karen Barr, ICAA General Counsel (copy enclosed).

INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.
1050 17TH STREET, N.W., SUITE 725 WASHINGTON, DC 20036-5503
(202) 293-ICAA FAX (202) 293-4223

The ICAA also supports strongly the limitation to the licensing requirements of proposed Rule 210 to only those employees of SEC-registered advisers who are investment adviser representatives with a place of business in Arizona. This change from the Division's previous draft is fully consistent with the Coordination Act. However, as we discussed in our telephone conversation, the dollar thresholds in that rule's definition of "excepted person" should be raised to $750,000 (for the amount of a client's assets under management) and $1.5 million (for the joint net worth of a married couple) to conform to recent changes to SEC Rule 203A-3(a).

In addition, the ICAA commends the Division on its continued support for exempting persons holding the Charted Investment Counselor qualification from the written examination requirements for investment adviser representatives set forth in Rule 204(A), consistent with NASAA's recently released sample rule on the subject.[3] As you know, holders of the CIC designation have met the rigorous standards of the Chartered Financial Analyst exam and have significant experience in portfolio management and investment counseling.

As we discussed last week, however, we still have significant concerns about several proposed rules that do not yet conform to the Coordination Act:

1. *Rules 206-209 Should Apply Only to Licensed Investment Advisers*

As we discussed in our August letter, the Coordination Act preempted "all regulatory requirements imposed by state law on Commission-registered advisers relating to their advisory activities or services,"[4] except, in relevant part, that states may *investigate and bring enforcement actions* for fraud and deceit against SEC-registered investment advisers. The plain language of the Coordination Act does not permit substantive regulation of federally registered advisers.[5] For this reason, in our August comments, we opposed Rules 201 and 205-209 as then drafted and requested that each of these provisions be amended to apply only to *licensed* investment advisers and their investment adviser representatives.

The Division accepted our August request with respect to Rules 201 and 205. For each of Rules 206-209, however, the Division simply inserted a subsection that states: "With respect to federal covered advisers, the provisions of this Section apply only to the extent the practice involves fraud or deceit and only to the extent permitted by Section 203A of the investment advisers act of 1940."[6]

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[3] The ICAA is in the process of finalizing a letter to all states urging uniform adoption of NASAA's competency examinations and the accompanying sample rule language.

[4] *Rules Implementing Amendments to the Investment Advisers Act of 1940*, 62 Fed. Reg. 28112 at 28125 (May 22, 1997) (Implementing Release).

[5] *See* ICAA letter to Ms. Farson (Aug. 31, 1998).

[6] These rules address custody (Rule 206), suitability (Rule 207), advertising (Rule 208); and financial and disciplinary disclosure (Rule 209).

While we appreciate the Division's efforts to respond to our comments, we respectfully disagree with the Division's approach. We understand that the Division takes the position that prophylactic rules are needed to form the basis for enforcement actions for fraud and deceit. However, the Division already has ample authority to pursue fraud and deceit claims without such rules; Arizona has a general antifraud provision, pursuant to which the Division has the authority, consistent with the Coordination Act, to bring any type of antifraud case, including, as a very small subset, the types of issues covered by the proposed rules.

The SEC recognized this concept when it eliminated application of its own prophylactic rules to state-registered advisers. The SEC stated:

> The Commission is amending these rules [its anti-fraud rules under Rule 206] to make them applicable only to advisers registered (or required to be registered) with the Commission. By excluding advisers not registered with the Commission from these rules, the Commission is not suggesting that the practices prohibited by these rules would not be prohibited by section 206. Rather the Commission recognizes that these rules contain prophylactic provisions, and that after the effective date of the Coordination Act, *the application of these provisions to state-registered advisers is more appropriately a matter for state law.*[7]

The SEC staff has specifically stated that the provision "limiting the [states'] authority to bringing enforcement actions [for fraud and deceit] *precludes a state securities commission from re-regulating advisers by issuing anti-fraud rules.*"[8] The SEC staff last year reaffirmed this position in a letter to a Colorado lawmaker concerning proposed Colorado legislation that would have imposed custody and disclosure requirements on investment adviser representatives employed by SEC-registered firms, contrary to the Coordination Act.[9]

As we discussed last week, in addition to being contrary to the Coordination Act, these proposed rules defeat the goal of uniformity among the states. To our knowledge, only one other state has amended its rules to apply prophylactic anti-fraud rules to federal covered advisers. This situation is not remedied by the Division's use of SEC rules as a basis for regulation. The ICAA has consistently objected to duplicative sets of regulations even where a state imposes the same standards as current federal regulations.

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7 Implementing Release, 62 Fed. Reg. 28112 at 28127-28 (May 22, 1997).

8 Memorandum dated May 16, 1996 from the Division of Investment Management to the Senate Securities Committee Staff, File Docket No. F7-98 (emphasis added). Indeed, the Division of Investment Management had recommended including the provision permitting state enforcement actions for fraud and deceit, because it believed that the Coordination Act would have preempted such authority unless specifically preserved. *Id.*

9 *See* Letter from Robert E. Plaze, Associate Director, SEC Division of Investment Management to the Honorable Ed Perlmutter, Colorado State Senator, dated March 10, 1998.

Not only are such regulations contrary to the Coordination Act, but standards that initially are identical may diverge over time, through amendments to regulations or guidelines or through differing interpretations issued by the various regulators.

Accordingly, we again respectfully request that each of these provisions be amended to apply only to licensed investment advisers and investment adviser representatives employed by licensed investment advisers.[10]

2. *Rule 201 Should be Consistent with NASAA Model Rule Language*

As we mentioned, we believe that the language of subsection (A) of proposed rule 201 is somewhat ambiguous because, in the context of state-registered advisers, it discusses requirements imposed on federal covered advisers. For clarity and uniformity, we suggest that the Division use NASAA's model language for books and records requirements, which simply requires state-registered advisers to comply with SEC Rule 204-2 notwithstanding that such advisers are not registered with the SEC.

3. *Rule 203 Should Be Amended to Reflect Limits Imposed by the Coordination Act*

For the reasons discussed above and in our August letter, we do not believe that the addition of Subsection (B) to Rule 203 governing dishonest and unethical practices is adequate because it does not exclude from the rule's purview investment adviser representatives of federal covered advisers. As we mentioned in our August letter, Rule 203 does not apply to SEC-registered advisory firms.[11] To avoid "backdoor" regulation of federal covered advisers through regulation of their investment adviser representatives, we again respectfully request that you amend the rule to apply only to licensed investment advisers and their investment adviser representatives.

4. *The Statute Should Specify Notice Filing Requirements*

Proposed Rule 212 does not specify which documents the Division requires for a notice filing pursuant to A.R.S. 44-3153(D)(1). We understand from our conversation with you that these requirements will be included in a new statutory provision. We therefore request that our August comment on this subject be considered for inclusion in the statutory proposal.

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[10] Rules 207 and 208, as currently proposed, would apply to investment adviser representatives employed by SEC-registered firms. Where a representative is acting on behalf of an SEC-registered adviser, however, the persons with whom he or she communicates are clients and prospective clients of the firm, not the representative. Thus, the effect of the proposed rules would be to regulate the activities of the SEC-registered firm, a result contrary to the Coordination Act.

[11] *See* ICAA letter to Ms. Farson (Aug. 31, 1999), at n.7.

We very much appreciate your consideration of the ICAA's comments. Please do not hesitate to call either me or Rachel Witmer, Counsel, if you have any questions or would like to discuss these issues further with us.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

Enclosure

ICAA

August 31, 1998

Ms. Cheryl T. Farson
Associate General Counsel
Arizona Corporation Commission,
Securities Division
1300 West Washington, Third Floor
Phoenix, AZ 85007-2996

RE: Proposed Changes to Investment Adviser Rules Pertaining to Arizona Investment Management Act

Dear Ms. Farson:

Thank you for extending us the opportunity to provide informal comments on the Securities Division's draft proposal to amend its regulations regarding investment advisers.

As you may know, the ICAA is a national not-for-profit association that exclusively represents SEC-registered investment adviser firms. Founded in 1937, our membership consists of more than 225 investment advisory firms that collectively manage funds in excess of $1.5 trillion for a wide variety of institutional and individual clients.

We commend you for your efforts in drafting the proposed rules. We have the following comments on the proposal:

1. *Rules 201 and 205-209 Should Apply Only to Licensed Investment Advisers.*

The purpose of the Investment Adviser Supervision Coordination Act (Coordination Act), Title III of the National Securities Markets Improvement Act of 1996 (NSMIA), was to eliminate overlapping and duplicative regulation by allocating regulatory responsibility for larger investment advisers to the SEC and responsibility for smaller advisers to the states. Congress accomplished this goal by preempting "all regulatory requirements imposed by state law on Commission-registered advisers relating to their advisory activities or services,"[1] subject to four specific exceptions: (1) states may require SEC-registered advisers to notice file; (2) states may require SEC-registered advisers to pay filing fees; (3) states may investigate and bring enforcement actions for

[1] Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 28112 at 28125 (May 22, 1997) (Implementing Release).

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1050 17TH STREET, N.W., SUITE 725, WASHINGTON, DC 20036-5503
(202) 293-ICAA FAX (202) 293-4223

fraud and deceit against SEC-registered investment advisers; and (4) states may license, register or otherwise qualify investment adviser representatives who have a place of business located in that state.

The plain language of the Coordination Act and accompanying legislative history prohibit states from imposing a second layer of regulation on SEC-registered advisers. Thus, for example, Senators Gramm and Dodd have stated that Congress intended the Act to "preempt not only a state's specific registration, licensing or qualification requirements, but *all regulatory requirements imposed by state law* on investment advisors relating to their advisory activities or services, except for those activities specifically identified in the statute [*i.e.* fraud or deceit]."[2]

In rules implementing the Coordination Act, the SEC emphasized that "state regulatory provisions, such as those that establish recordkeeping, disclosure, and capital requirements, will no longer apply to advisers registered with the Commission."[3] The SEC also has correctly interpreted the Coordination Act to prohibit states from re-regulating SEC-registered advisers through the back door of defining "dishonest or unethical" business practices, except to the extent those practices would otherwise constitute actual fraud or deceit. In providing technical assistance to Senate personnel drafting the Coordination Act, the SEC staff stated that the provision "limiting the [states'] authority to bringing enforcement actions [for fraud and deceit] *precludes a state securities commission from re-regulating advisers by issuing anti-fraud rules.*"[4]

The Securities Division's proposed rules regarding books and records (14-6-201), brochure rule (14-6-205), custody (14-6-206), suitability (14-6-207), advertising (14-6-208), and financial and disciplinary disclosure (14-6-209) would apply to all investment advisers, rather than solely investment advisers that are licensed in Arizona. Thus, these proposed rules do not conform to the Coordination Act.[5] We therefore respectfully request that each of these provisions be amended to apply only to *licensed* investment advisers and investment adviser representatives employed by *licensed* investment advisers.[6]

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[2] Letter dated April 25, 1997 to SEC Chairman Arthur Levitt from Phil Gramm (R-Tex) and Christopher J. Dodd (D-Conn), at p. 1 (emphasis added).

[3] Implementing Release, 62 Fed. Reg. 28112 at 28125 (May 22, 1997).

[4] Memorandum dated May 16, 1996 from the Division of Investment Management to the Senate Securities Committee Staff, File Docket No. F7-98 (emphasis added). Indeed, the Division of Investment Management had recommended including the provision permitting state enforcement actions for fraud and deceit, because it believed that the Coordination Act would have preempted such authority unless specifically preserved. *Id.*

[5] The Arizona legislature clearly indicated its intent to comply with the Coordination Act's preemption provisions by limiting its requirements governing financial statements to *licensed* investment advisers. A.R.S. 44-3159(C).

[6] Rules 207 and 208, as currently proposed, would apply to investment adviser representatives employed by SEC-registered firms. Where a representative is acting on behalf of an SEC-registered

2. *Rule 203 Should Be Amended to Reflect Limits Imposed by the Investment Advisers Supervision Coordination Act.*

For the reasons discussed above, we do not believe that the provisions regarding dishonest and unethical business practices apply to investment adviser representatives of federally-registered advisers.[7] Therefore we suggest that you amend Rule 203 to refer to "licensed investment advisers and their investment adviser representatives."

3. *Rule 201 Should Be Conformed to Section 222 of the Investment Advisers Supervision Coordination Act.*

Section 222 of the Coordination Act provides that "[n]o State may enforce any law or regulation that would require an investment adviser to maintain any books or records in addition to those required under the laws of the State in which it maintains its principal place of business, if the investment adviser – (1) is registered or licensed as such in the State in which it maintains its principal place of business; and (2) is in compliance with the applicable books and records requirements of the State in which it maintains its principal place of business." The Arizona legislature clearly intended that Arizona law comply with this provision, as A.R.S. 44-3159(C) governing financial statements properly implements Section 222. We therefore respectfully suggest that Rule 201 be amended by adding a provision similar to A.R.S. 44-3159(C).

4. *Licensing of Employees of SEC-Registered Advisers Should Be Limited to Investment Adviser Representatives with a Place of Business in the State.*

Arizona's current definition of "investment adviser representative" is not consistent with the SEC's definition of "investment adviser representative" for representatives of SEC-registered advisers. Recognizing that this is probably a matter for legislation rather than rulemaking, we nevertheless would encourage the Division to support adoption of the SEC's definition. Further, under the Coordination Act, representatives of federally-registered advisers need apply for licensure only if they have a place of business in Arizona. We urge the Division to propose legislation that expressly incorporates this requirement.

5. *The Proposal Should Specify Notice Filing Requirements.*

The current proposal does not specify which documents the Division requires for a notice filing pursuant to A.R.S. 44-3153(D)(1). Presumably, like last year, the Division plans to issue a letter setting forth the requirements. We encourage the Division to

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adviser, however, the persons with whom he or she communicates are clients and prospective clients of the *firm*, not the representative. Thus, the effect of the proposed rules would be to regulate the activities of the SEC-registered firm, a result that is contrary to the intent of the Coordination Act.

[7] Proposed Rule 203 would not apply to SEC-registered advisory *firms* because A.R.S. Sec. 44-3201(A), which Rule 203 implements, relates to denials, suspensions, and revocations of licenses. This result is consistent with the Coordination Act.

include such requirements in a new rule 14-6-106, so that all advisers are aware of the requirements whether or not they receive a letter from the Division. We understand that most states revising their rules to conform to the Coordination Act have chosen to include such a provision in their rules.

We suggest the following language: "The notice filing required by A.R.S. Sec. 44-3153(D) shall consist of: (a) a copy of Form ADV as most recently filed with the Securities and Exchange Commission; (b) a consent to service of process in Arizona or an originally executed copy of page 1 of Form ADV; and (c) a notice filing fee in the amount of $250.00 payable to the Arizona Corporation Commission." Similarly, if the Division wishes to require annual or "renewal" notice filings, we would encourage inclusion of that requirement in a rule. We would be pleased to work with the Division on language for any such requirement.

We truly appreciate your consideration of our comments. Please do not hesitate to call me or David Tittsworth, Executive Director, if you have any questions or would like to discuss these issues with us.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel